



THE CHAIRMAN

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

December 31, 2002

The Honorable John D. Dingell
Ranking Member
Committee on Energy and Commerce
2322 Rayburn House Office Building
U.S. House of Representatives
Washington, DC 20515-6115

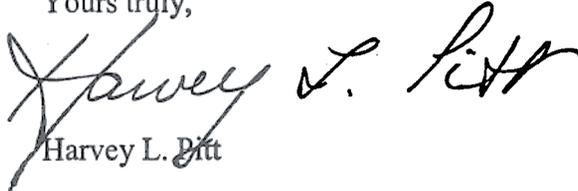
Dear Congressman Dingell:

In September 1998, you asked the Commission to provide you with annual progress reports, through the year 2003, on SEC and industry initiatives to improve corporate bond transparency. Today, I am pleased to provide this fifth in a series of annual reports, prepared by the Division of Market Regulation.

The report notes that, during the past year, the NASD implemented its TRACE proposal for reporting and disseminating last sale information on corporate bonds. I believe that the implementation of TRACE will greatly increase the transparency of the corporate bond market and enhance the ability of the NASD to conduct surveillance of this important market. In addition, the report notes that the number of alternative trading systems that trade debt securities has remained relatively unchanged during the past year, reflecting substantial industry consolidation in this market.

Please do not hesitate to call me at (202) 942-0100 or Annette Nazareth, Director of the Division of Market Regulation, at (202) 942-0090 if we can be of further assistance.

Yours truly,


Harvey L. Pitt

Enclosure

MEMORANDUM

TO: Chairman Pitt

FROM: Annette L. Nazareth, Director *ALN by RLDC*
Division of Market Regulation

RE: Corporate Bond Transparency

DATE: December 31, 2002

In September 1998, Congressman John D. Dingell asked the Commission to submit annual progress reports to the House Committee on Energy and Commerce regarding corporate bond transparency. These reports, to be provided through the year 2003, are to contain a discussion of regulatory and industry initiatives in this area to permit the Committee to determine how much progress has been made. This memorandum summarizes developments during the past year regarding the National Association of Securities Dealers, Inc.'s ("NASD") TRACE proposal and the operation of alternative trading systems under Regulation ATS under the Securities Exchange Act of 1934 ("Act").

1. NASD's TRACE Proposal

As we reported last year, on January 23, 2001, the Commission approved the NASD's proposal to establish the TRACE system for reporting and dissemination of last sale information on corporate bonds.¹ During the past year, the NASD implemented TRACE and established initial fees for its users. Specifically, on July 1, 2002, TRACE commenced operations. During the first three months of operation (Phase I), TRACE received transaction reports on almost all U.S. corporate bonds and began to immediately disseminate transaction information on publicly offered investment grade corporate bonds with initial issuance size of \$1 billion or greater, and on high-yield debt securities called the "FIPS-50."² The data disseminated through TRACE represented about one-

Securities Exchange Act Release No. 43873 (January 23, 2001), 66 FR 8131 (January 29, 2001) ("Approval Order").

² The "FIPS-50" are 50 high-yield corporate debt issues that were previously subject to dissemination of hourly trade summaries under the former Fixed Income Pricing System ("FIPS") operated by the Nasdaq Stock Market, Inc. FIPS was replaced by the TRACE system.

half of the dollar value of trading activity in investment grade bonds during that period and is currently carried by several information vendors. In addition, the data reported to TRACE, representing essentially all trading activity in corporate bonds, is now available to the NASDR for surveillance purposes.

Under the terms of the Approval Order, the NASD, after consulting with the Bond Transaction Reporting Committee (“BTRC”), an advisory committee of industry representatives, is required to consider expanding the universe of bonds that are subject to dissemination through TRACE. Recently the NASD Board considered and approved a proposal that will result in publication of transaction reports for about 75% of the dollar value of trading activity in investment grade corporate bonds.

We believe that dissemination of last sale data on corporate bonds through TRACE has significantly improved the transparency of the corporate bond market. Moreover, we also believe that the availability of TRACE-reported data to NASDR will greatly enhance its ability to conduct effective surveillance of this market.

2. Alternative Trading Systems

The number of alternative trading systems that trade debt securities has remained relatively unchanged from last year. Today, out of an estimated 46 alternative trading systems that operate pursuant to Regulation ATS, the staff estimates that roughly 24 systems trade debt securities. That number represents an increase of only 4 percent relative to the 23 debt systems that the staff estimates were in operation at this time last year. The relative stagnancy in the growth rate of alternative trading systems for debt securities reflects a significant consolidation in the industry as trading firms have merged to form new entities or ceased operations entirely. In addition, the relative trading volume of these systems continues to remain low.